

**HUNGARY**

**REAL ESTATE LENDING  
POLICY AND PROCEDURES  
MANUAL**

Prepared for

**USAID**



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# **REAL ESTATE LENDING POLICY AND PROCEDURES MANUAL**

## **INTRODUCTION**

This Real Estate Lending Policies and Procedures Manual (the Manual) was originally developed in 1996 as part of a project in Eastern Europe sponsored by the United States Agency for International Development (USAID). The project took 11 months and involved five local banks. In 1998 the Manual was used for several USAID-sponsored training seminars in Hungary with real estate developers and bankers in three cities (Budapest, Nyiregyhaza, and Zalaegerszeg). One of the primary goals of the seminars was to engage developers and bankers in a dialogue and to strengthen the bankers' ability to identify, analyze, monitor, and collect real estate loans. Following the seminars, the Manual was edited to reflect Hungarian banking practice and documentation as well as market conditions.

The Manual is intended to serve as a general guide, not as a comprehensive authority, on the subject of real estate lending. Furthermore, sufficient training and other technical assistance are recommended before a bank undertakes a significant amount of real estate lending. The Manual does provide the means by which banks in Hungary can begin to analyze real estate lending and focus on organizational as well as capital implications. We also urge that banks involve their counsel in this process to ensure due consideration to local law and compliance with national laws, including banking regulations.

We wish to acknowledge the support of USAID and the valuable assistance of Hungarian and American experts, including Mr. Ákos Torma of HYPO Bank, the management of OTP Bank, Pál Baross (KOLPRON Budapest Kft.), Frank Piatkowski (Charles E. Smith Companies/ PADCO), the Urban Institute of Washington, D.C., and the Metropolitan Research Institute, Budapest.

We hope the Manual is a useful tool for developing a successful and profitable real estate loan department for your bank.

## **CHAPTER 1: ESTABLISHING A REAL ESTATE LOAN POLICY**

### ***Introduction***

A real estate Loan Policy is recommended for lending institutions that plan to originate a significant amount of real estate loans. For the purpose of this Manual, a real estate loan is a loan made to a developer or builder engaged in the construction of housing where real estate is the collateral for the loan. A formal Loan Policy establishes a written set of rules, as well as clear limits on the types of real estate loans that are permitted. The Policy should provide for flexibility. For example, policy exceptions may be allowed as long as conditions and procedures are explained.

Once approved by the Board of Directors, the final text of the Loan Policy should be circulated to the appropriate real estate lending officers, who should be required to read and acknowledge their understanding in writing. Management should consider staff meetings to review

the Loan Policy with the staff.

### **Key Elements of a Loan Policy**

**Loan Approval.** Loan approval authority for individual officers, loan committees, and the Board of Directors should be set forth in detail in the Loan Policy. The staff and management can thus refer to the Loan Policy to resolve any approval issues. Larger loans are normally reported to the senior officers or the Board of Directors, and the Loan Policy should require this practice. Detailed records should be kept of loans so reported and a designated senior credit officer should personally sign the minutes of any meetings. In this way, there is clear evidence that Loan Policy guidelines have been followed and that policy exceptions have been properly documented.

**Legal/Prudent Lending Limits.** Local or hard currency exposure limits should be set for any one borrower or guarantor. The limits will not exceed those established by national or local banking regulations. In cases where more than one loan is outstanding to a single borrower, or an affiliate or subsidiary of a borrower ("Group Credits"), any request for additional credit shall be added to the maximum exposure under existing loans and commitments. *In no event should the Group Credit be permitted to exceed the limit on loans to a single borrower, established by the Board of Directors, by banking laws, or by banking regulations.*

**Limits by Property Type and Type of Loan.** It may be advisable to set limits based on a certain percentage of the market value of the collateral or the cost of construction of the finished property. Monetary limits may be set for different types of property and types of loans, for example, "loans for multifamily projects should not exceed a certain amount of forints or a certain percentage of the Bank's capital." Specific loan limits can be set for single-family and other housing projects as well.

**Geographical Limits.** Geographical limits should be set, beyond which the bank will not consider loan applications, or perhaps only on an exception basis. For example, a bank may wish to limit its lending activity to an area within a certain kilometer radius of its main office, or the branch office where the loan will be housed and serviced. As a rule, the property should be in an area where the bank is familiar with the market demand and values of comparable properties.

**Customer Profile.** This section will describe the desired credit customer. A bank may prefer lending only to existing customers of the bank, developers known to the bank, certain types of developers of housing projects, non-speculators, etc. A bank may prefer to lend only on existing improved properties, and not on projects involving extensive construction or renovation. Where project development is concerned, the bank may want to avoid separate loans for land acquisition (or leasehold acquisition), site development (grading, curbing, utilities, etc.), or construction, as it is usually prudent to review the project loan request as a whole. Regardless of the guidelines

established, the bank should only consider financing experienced builders or developers who have established a record of successful operations or completion of similar properties and a reputation for honesty and integrity and who can demonstrate adequate financial strength.

**Credit and Underwriting Standards.** Guidelines should be established for underwriting real estate loans, including maximum loan-to-value ratios for various loan categories, minimum debt service coverage, amount of borrower equity required, expected source of repayment (e.g., income from rentals or proceeds from sale of the property, a loan commitment, or guarantee from another financial institution), loan maturity, and other standards.

**Loan Security.** All loans should be secured by a first mortgage on existing property or property to be developed. The value of such property, or any other real estate taken as collateral, should be established by an appraisal to ensure an adequate loan-to-value margin. If there is no legal restriction, it may be advisable to require other collateral besides the mortgage, such as the registration of option rights, and other items, such as bail, personal guarantees, and assignments. Second mortgage loans and other junior liens should not be considered adequate primary collateral for real estate loans, but may be acceptable in the case of real estate pledged as additional collateral.

**Loan Monitoring.** Procedures should be established to monitor lending activity in terms of legal and bank limits on the loan amount, property type and loan type, and geographical guidelines, to ensure compliance with bank policy. Such procedures will include regular reports to bank management.

**Other Real Estate Related Loans, Bank Guarantees, or Letters of Credit.** Loans for working capital or other corporate purposes, bank guarantees, letters of credit, and other non-real estate loans secured by real estate may be governed by a bank's standard lending policy. With respect to documentation and procedures, the bank's real estate policies should be followed. Such undertakings by the bank should be considered extensions of credit for the purpose of computing lending limits and total credit exposure to any one borrower/guarantor. (See Group Credit reference above.)

**Pricing, Fees, and Other Charges.** Recommended interest rates and fee schedules may appear in the Loan Policy or in another written document circulated among the management. A bank may select a range of rates and fees, depending on the risks of a loan, the overall relationship with the customer, etc. The interest margin earned on a real estate loan should reflect the risk of the transaction as perceived by the bank, i.e., the type of property being financed, the assessment of the developer, the way the property is used (sale or lease), the maturity of the loan,



etc.

**Overall Goal of the Loan Policy.** The main goal of a Loan Policy is to promote a high-quality real estate loan portfolio. Real estate lending involves risks not encountered with traditional corporate and consumer loans. However, bank lending for housing projects is generally considered less risky than commercial real estate projects (office buildings, shopping centers, etc.), particularly where there is a significant need for housing. The quality of a bank's real estate loans will depend on an accurate evaluation of the real estate taken as collateral, a proper assessment of the demand for the underlying real estate product, and continued monitoring throughout the life of the loan. Careful analysis, documentation, and adherence to sound business practice consistent with the bank's established loan policy will neutralize risk inherent in real estate lending and allow a rewarding and successful program to go forward.

## **CHAPTER 2: REAL ESTATE LENDING: DEPARTMENT ORGANIZATION**

### ***Introduction***

A real estate lending department ("Department") is usually organized as a centralized unit within the main office. Some banks prefer to have real estate representatives in other departments and in branch offices, where real estate lending will be carried out. Moreover, management may decide to combine housing loans with commercial loans (office buildings, shopping centers, etc.), although the procedures involved and the levels of complexity are not identical. For example, the construction lending function for commercial loans involves additional steps during the underwriting and operational stages. A bank that is just getting started in real estate lending may find it expedient to have multiple functions performed by a certain level of staff and to let market forces and the growth in loan volume dictate the need for additional staff.

### ***Job Titles and Job Descriptions***

Typically, a Department is separated into two units: a Lending Unit and an Operations Unit. Each unit has subunits that have staff commensurate with the volume of work. As mentioned above, some of these functions can be combined for housing and commercial loans. The Legal and Appraisal functions are assigned to a specific lawyer or appraiser in the bank's legal and appraisal departments. If the loan portfolio and volume warrant the extra costs, the Legal and Appraisal Functions may be assigned directly to the Department and to its cost center.

**Unit: Lending.** Once again, these functions can be combined

Job Title	Description
Loan Officer	Calls on new and existing customers to generate new business. Conducts all correspondence with the customer. Receives and screens loan applications. Works with the customer to obtain all information needed for the bank to make a timely loan decision.
Underwriter	Analyzes borrowers, guarantors, projects, companies, etc. Contacts appraisers, engineers, lawyers and others. Completes a written analysis of loan application and presents the recommendation to a senior manager or loan committee.
Collection / Workout Officer	Reviews past due list and reports on status to senior lender. Coordinates with loan officer, branch officers, and others in the collection of problem loans. Responsible for meeting collection guidelines. Works with senior management, lawyer, and others on loan workouts, litigation, and foreclosures.

**Unit: Operations.** These functions can be combined. In this example, the Legal and Appraisal Functions are provided by professionals from other departments. Banks with large real estate portfolios can justify the expense of having at least one lawyer and appraiser assigned to the Department.

Job Title	Description
Loan Administrator	Monitors construction loans and is responsible for advancing draw requests after consulting with loan officer, engineer, inspector, lawyer, and others. Understands and maintains the loan documents. Promptly reports problems to loan officer. Reports errors to accounting after reviewing reports. Coordinates closing dates. Coordinates inter-branch operations. Arranges for cash count every day for department. Coordinates the generation of invoices. Responsible for activities with MIS (management information systems) and other operation areas.
Accounting	Records all payments and advances involving the customer, posts to the proper account, generates reports, produces invoices, handles accounting inquiries, prepares amortization schedules, accepts and accounts for principal repayments including prepayments, and processes fully paid loans.
Insurance	Responsible for keeping up to date records on insurance, including hazard, property, liability, and life. This section will manage insurance policies and escrow payments that are required in loan agreements.

Job Title	Description
Filing	Responsible for keeping all files and records of the Department. Records and official documents should be kept in a disaster-proof location. Back up records should be maintained at a remote location, which will allow for reconstruction of records, in case of emergency. All original documents such as title papers, insurance policies, promissory notes, mortgages, etc. should be kept separate from the file in a specially designated vault file, identified by the loan account number, and under controlled access. Responsible for handing over documents to legal department on fully paid loans after receiving a written request from the accounting department. When volume reaches a high level, management may consider using computer software to house a fully automated filing system.

## Work Flow

Real estate lending can be a profitable and a reasonably safe lending activity when a bank's loan policy and work flow are designed to accommodate increases in volume. A bank that anticipates only a modest volume of real estate lending perhaps does not need to develop a formal real estate work flow. However, a bank that experiences a high volume of real estate lending without a well-conceived work flow is not prepared for the problems that are sure to follow. In any case, as real estate lending becomes more common, banks should review their work flow in order to:

- Present and define a clear and consistent process for underwriters and customers.
- Create a work flow that is efficient and able to respond to customer requests in a reasonable amount of time.
- Establish prudent standards for loan underwriting that will result in a stronger loan portfolio and fewer problem loans.

**Loan Policy.** The assumption is made that a bank anticipates a sufficient volume of real estate lending and develops a formal Loan Policy (see Chapter 1).

**Loan Application.** A bank may prefer a printed loan application form. Such a form organizes the financial and other information in a consistent format that is generally easier for the underwriters and other loan department staff to use. It also forces the bank customer to present information in the desired format. The application form may be completed by the customer and submitted to the bank or, preferably, developed jointly by the loan officer and the customer through an interview process.

Instead of a printed application, a bank may prefer a checklist of required information and exhibits, corresponding to the essential points of information in the bank's internal loan approval

presentation. With either approach, the loan officer is able to determine when the application is complete and ready to proceed. Experience has proven that the best time to obtain complete and accurate information is at the application stage, when the customer is made to understand that the loan request will not proceed until the customer has complied. Once a loan has closed and disbursements have been made, the customer's interest is centered elsewhere and there is less incentive to provide the requested information.

Other important steps at the application stage are:

*Credit Check.* Check bank, trade, and credit references and other sources to determine the customer's business and borrowing history.

*Project Review.* Conduct a preliminary review of the project to determine feasibility and compliance with bank policy.

*Independent Contractor.* If a project involves an independent contractor, investigate the experience and reputation of the contractor and review the construction contract.

**Loan Underwriting.** Underwriting is one of the critical stages in the lending process. Poor underwriting standards and procedures will result in poor loan decisions and bad loan experiences. The Loan Policy of the bank should set forth the acceptable levels of underwriting ratios (e.g., maximum loan-to-value, minimum debt service coverage) and other criteria that bank management wishes to establish. The underwriters will analyze the borrowers, the guarantors, the contractors, the project, and the market and either review existing appraisals or arrange for a new appraisal. Exceptions to Loan Policy are acceptable if approved in writing by the appropriate level of management.

**Loan Approval.** Loan approval authority for individual officers, loan committees, and the Board of Directors should be set forth in detail in the Loan Policy.

**Loan Closing.** The following events take place at a loan closing.

Final terms of the loan documents are negotiated.

Legal documents drafted by bank counsel and executed.

Attorneys representing the bank and the borrower render legal opinions and advice on important legal issues.

Key documents including mortgages are notarized, filed, and recorded.

Loan proceeds are disbursed.

Loan information is entered into the bank's records to form the basis for accounting, financial statements, reporting, and periodic billing of interest and principal payments on the loan.

It is obvious that improper handling of these functions can lead to losses. Management must periodically review the closing practices and loan loss record to see if changes are needed.

**Loan Advances.** The loan agreement and other closing documents govern the method of disbursement of loan proceeds. A loan secured by existing real estate will normally entail a single disbursement. A real estate construction or renovation loan will more likely call for periodic advances in accordance with an agreed schedule. Great attention to the methods and details of disbursement is required to avoid mistakes and potential losses. This subject will be covered in a later chapter.

**Loan Monitoring.** The Loan Policy should emphasize the importance of loan monitoring. Depending on the size of a loan, a borrower may be required to submit periodic financial statements during the loan term, as well as updated statements of income and expenses of the property taken as collateral, and rental and sales information. Loan Department staff should review this information, conduct a physical inspection of the collateral, and obtain updated appraisal information as appropriate. Smaller loans may require only a physical inspection and analysis of the payment history. The staff should also monitor payment of taxes, insurance premiums, licenses and other required fees, and the status of the title to the property held as collateral.

**Payment and Collection.** This important function includes the billing of interest and principal payments, fee invoices, posting of entries to the general ledger, and reconciling all records between departments. Inattention to payment and collection procedures can be quite serious, as delinquencies can quickly accelerate into problem loans. Problem Loan Administration will be discussed in a later chapter.

## CHAPTER 3: LOAN DOCUMENTATION

### *Introduction*

Real estate lending generally involves the services of a lawyer for legal review and documentation. The enforceability of loan documents may well determine the rights and remedies of the lender concerning the borrower, the guarantor, and the real estate used as collateral for the loan. Therefore, strict adherence is critical to local, national, and banking laws and experienced legal assistance is strongly recommended.

The loan documents presented in this chapter are for illustration purposes only. We gratefully acknowledge the contributions of OTP Bank, Metropolitan Research Institute, and the ENHR Conference in Budapest, Hungary (September 1993) for their assistance with these documents. However, banks should consider these loan documents for illustration purposes and consult their own counsel regarding enforceability and appropriateness for actual loan documentation.

### ***Loan Documents***

See Annex.

Loan Application

    Supplement #2 of Loan Application

    Supplement #3 of Loan Application

Loan Agreement

Mortgage Deed: Upon Real Estate

    Mortgage Deed: Skeleton Security Mortgage Upon Real Estate

Mortgage Deed: Upon Chattels (relating to a loan involving Real Estate)

    Mortgage Deed: Skeleton Security Mortgage Upon Chattels

Mortgage Deed: Upon Property and Part of Property

    Mortgage Deed: Skeleton Security Mortgage Upon Property and Part of Property

Announcement: Mortgage Encumbering Property

Agreement: For Common Sale of Chattels Encumbered with Mortgage

Enforcement (see Residential Loan Recovery: Managing Risk of Default; Report of the Loan Recovery Working Group by Rabenhorst et al., November 1998)

## **CHAPTER 4: LOAN APPLICATION**

### ***Introduction***

The loan application serves at least two purposes: as a formal request for the extension of credit on specific terms and as an organizer for the information required to be underwritten before the department can proceed with the real estate loan request.

### ***The Loan Application***

The loan application should include:

- Name of borrower
- Legal structure of borrower (e.g., partnership, corporation)
- Legal address of borrower
- Amount of loan requested
- The required maturity and the source of repayment (a business plan showing the financial sources of repayment unless covered in a feasibility or marketing plan)
- Purpose of loan—acquisition, renovation, conversion, construction (note: construction loan would have additional requirements)
- Property name, if applicable
- Proof of ownership of the property (usually a registry sheet not older than 30 days) and the documents proving the way the property was acquired and the value of the property
- Property address
- Dimensions of site
- Description of improvements
  - Number of floors
  - Number of units
  - Square meters of space
  - Type of construction
  - Age of improvements
  - Elevator
  - Amounts of office, retail, industrial space
  - On-site parking
  - Title—Freehold, Leasehold—terms of lease, renewal options

### ***Addenda***

The application should call for additional information to be attached as addenda. This would include:

- Financial statements of borrower
- Financial statements of third-party guarantors
- Bank and trade references
- Property operating data—income and expense statements covering several years of operation



**Signature Page**

The application should contain a section requiring the signature of the borrower certifying that the information submitted is correct and authorizing the bank to conduct such investigations as it sees fit, including contacting bank and trade references.

**Completion/Submission**

The application should be completed by the borrower and submitted to the bank for review and acceptance or rejection. It is preferable, particularly in the early stages of a new loan program, for the bank and the borrower to develop the application information jointly in one or more face-to-face meetings. This should result in better-quality information and a smoother application process. It should also result in a lower rejection rate, because there will be more information gleaned from the interviewing process, and only applications with a successful conclusion will be accepted. The application document serves as an information checklist during the preliminary loan discussions.

**Project Review**

With the application completed and required supplemental information in hand, the bank can make a preliminary assessment of the property and determine whether the loan application merits further review. For example, an opinion can be formed as to:

*Quality of the security.* Based on age, type of construction, and materials.

*Compatibility with surrounding areas.* Whether the property is a conforming use, i.e., a single-family housing project is conveniently located with within close proximity of schools, shopping areas, and transportation.

*Property economics.* For a multifamily project, whether historical or projected revenues will support the operating/selling expenses and required debt payments.

*Sources and uses of cash to build the project.*

**Policy Review**

At this stage, the bank should also determine that the loan requested conforms to the written Real Estate Loan Policy approved by the bank's Board of Directors, in terms of loan size, geographical limitations, type of property, and whether property is owner-occupied or used for investment purposes.

## ***References***

The initial meeting should be used to determine if the borrower and other essential parties, including guarantors and contractors, have provided sufficient references for the bank to establish their credit histories. Any parties to the transaction who are not known to the bank should be required to submit a resume of their business history certified as true, correct, and complete.

## **CHAPTER 5: UNDERWRITING PROCESS**

### ***Introduction***

The successful underwriting of real estate loans requires:

Careful analysis and well-reasoned conclusions with respect to the real estate project itself  
and other real estate offered as collateral  
Skillful analysis of the financial strength and professional experience of the borrower.

These factors are of equal importance.

### ***Property Analysis***

From the information contained in the loan application and accompanying documentation, and from a preliminary inspection of the project site by the underwriter, the bank should be able to assess the viability of the property as collateral and whether the property (or proposed property) is being used at its highest and best use.

The bank should require reports/documents from internal or independent experts, such as appraisers, engineers, and attorneys. This will help protect against a conflict of interest, such as a situation where the borrower provides his/her own appraisal, showing a high, unrealistic value in order to obtain a larger loan amount. If a report is prepared by an independent expert, then the cost should be paid by the borrower. The estimation of value by an independent appraiser is of critical importance. Therefore, the bank should establish sound policies regarding the use of appraisals and appraisal expertise. Attached as an exhibit is an Appraisal Policy and Procedures Manual that may be a helpful guide.

## ***Location***

It is recommended that the analyst, at a minimum:

Determine whether the property site is in a desirable location in relation to its street, neighborhood, city, etc.

Determine whether the present or proposed use is compatible with the surrounding structures and property uses.

Determine the availability of critical infrastructure: road access, public transportation, sewers, schools, shopping areas, recreation areas.

## ***Improvements***

Professional engineers are very helpful to underwriters in analyzing projects.

**New Construction.** Engineer reports can serve several purposes: verify the borrower's estimate of total project costs (hard and soft) to complete the project, comment on the experience level needed by contractors to complete the project, accuracy of time needed to complete construction, etc.

**Existing Structures.** A visual inspection by the engineer will allow for a preliminary assessment as to the quality of the structure, state of repair, and level of maintenance. The underwriter's inspection should be supplemented by an inspection using a qualified engineer. The bank will furnish the engineer with building plans in sufficient detail to assess the quality of construction. The engineer's review should include an estimate of the cost of needed repairs and a recommendation as to any reserves for replacement that should be considered when analyzing the property income.

## ***Appraisal***

The underwriter may perform a preliminary valuation of the property and later arrange for a market value appraisal of the property by a qualified appraiser. The appraiser will use his observations upon inspection of the property, as well as his general knowledge of the area and market, to arrive at a market value of the property. The appraisal should confirm any assumptions of the property:

Desirability of the site location

Appropriateness of intended use

Availability of essential services

Highest and best use of the subject property, in terms of profitability, market demand,

zoning, and other considerations

The appraisal should also include a professional opinion on whether the proposed rent or price per square meter is competitive and on the anticipated absorption of any vacant space.

In the past, a large percentage of appraisals performed in developing real estate markets are based on the “cost approach” and not market conditions. The cost approach generally does not produce a reliable value.

### ***Feasibility and Market Study***

Where the property offered as collateral represents a new or innovative use, and particularly for new construction, the bank should consider a feasibility or market study. This can be conducted by bank personnel, but more likely would be performed by an outside marketing firm under contract to the bank and paid for by the borrower. The purpose is to assess the financial viability of a new project and determine whether, in fact, there is a market for the space at the sales or rental prices that are projected.

In Hungary, it is not unusual for commercial or retail tenants to occupy the ground floor in the small to moderate-size multifamily buildings. Thus, the study should consider the market for renting to such tenants.

### ***Economic Analysis***

The underwriter should perform a “sources and uses of cash” analysis of the project, which involves identification of all funding sources for the project—borrower equity, investor funds, bank funds, cash from sales of the units, etc.—and determine that enough funding exists to complete the project after considering all hard and soft costs, financing costs, owner profit, contingencies, etc.

The bank can complete its analysis once it has received historical income and expense statements (for existing projects) and projections of financial performance, a property appraisal, and the engineer’s report. A monthly cash budget for the project should be prepared by the borrower and carefully reviewed by the underwriter who will make the necessary adjustments.

The following tools may be used to analyze the project.

**Loan-to-Value Ratio.** *Loan/Value.* Under Hungarian law, banks cannot lend more than 70

percent of the “registered value” of the collateral. The Real Estate Loan Policy of the bank should establish maximum loan amounts based on the “appraised” or “market value” of the property. Prudence would dictate lower loan/value ratios for older properties or higher risk situations. Values change and, if value increases, the bank’s security position is enhanced, but, if value decreases, then the bank’s security position may be weaker depending on the amount of principal repaid on the loan. With prudent loan-to-value ratios set by the bank, there is a cushion of protection if the value of a property should decline. In practice, Hungarian banks normally require very conservative loan-to-value ratios relative to Western standards. Overly conservative loan-to-value requirements are not conducive to a healthy housing construction market.

**Net Operating Income (NOI).** *Cash Income Less Expenses, sometimes referred to as “Cash Flow.”* This calculation is usually used to determine the financial strength of multifamily rental projects. The bank should compare the actual or projected cash income and expense figures submitted by the borrower with similar properties in the immediate market area on a per square meter or per unit basis. Unrealistic income and expense figures will lead to erroneous calculations. The purpose is to arrive at a realistic cash flow or net operating income (NOI) for the property. Expense levels are clearly as important as income in this analysis. Low repair charges may indicate a poorly maintained building. A building managed by an owner-operator could be more expensive to run, as more management fees are typically paid compared to third-party management situations. Therefore, the bank is usually required to make adjustments to reflect market conditions.

**Debt Service Ratio.** *NOI Less Reserves/Annual Interest and Principal Payments.* The Bank Officer should also adjust for any replacement or other reserves recommended by the engineering report. The adjusted NOI is compared with the proposed loan’s debt service of projected interest and principal payments. The typical requirement is that NOI cover debt service a minimum of 1.25 times. A higher ratio of 1.5–2.0 times would be appropriate for properties where the NOI has been or is expected to be unstable. A debt service ratio of 1.15 or 1.1 may be appropriate for a property occupied by a single, high-credit tenant, paying some or all of the property operating expenses. For example, such a tenant may be a highly regarded Hungarian company that rents out an apartment building for its employees in accordance with a long-term lease and the company is responsible for the rental payments each month on all of the units.

**Borrower Equity and Liquid Assets.** *Cash or marketable securities to invest as equity in the project are good examples.* If the bank is financing the purchase of real property, a 70 percent loan-to-value ratio would indicate that the borrower will be investing 30 percent of its equity toward the purchase price. The source and certainty of the borrower’s equity should be ascertained before the bank becomes deeply committed in the underwriting process. If the required funds are available in cash or liquid investments as shown on the borrower’s or guarantor’s financial statement, there is some assurance that the cash equity exists. If the equity is to be borrowed or

acquired from other sources, the availability should be confirmed and the effect of additional debt on the borrower's financial condition should be analyzed as well as its effect on other assets of the borrower.

If the bank is financing new construction, it is to the bank's advantage if the borrower's equity is invested into the project prior to any advance of loan proceeds. If cost overruns during construction necessitate additional equity investment, it should be negotiated before any further advance of loan proceeds. The basic rule is that the bank should at all times have the funds in hand and in the loan budget to finish the job.

In Hungary, cash paid by the buyers of housing units often represents a significant percentage of the "borrower's equity," which is actually not the borrower's own capital but an outside source that the borrower used under its own name. In reality, these funds do not strengthen the borrower's ability to take risks. Therefore, the bank should closely monitor the sales of the housing units and the distribution of the cash proceeds from the buyers.

**Market Threshold (Preleasing, Presales).** Where a request for financing involves a vacant or largely vacant building and the bank must rely entirely on projections of income or sales, it would be prudent to impose requirements. Such requirements could include that before the bank will advance any loan proceeds 1) 50 percent of the space be leased at a specified minimum average rent per square meter, or 2) 50 percent of the space be sold at a specified minimum price per square meter or unit. Such requirements will confirm that a market does exist for the property at the projected rent levels or sales prices, and the requirements will reduce the ongoing marketing risk if the bank should have to take over the property.

**Minimizing Risk.** The bank can minimize its risk involving project loans in a number of ways. For example, if the size of the project appears ambitious given the market and/or the resources of the borrower, it may be possible to complete the project in stages (sometimes referred to as phases). In this way, the second stage of the project is not funded by the bank loan until the first stage is completed and most of the units are sold. The same procedure would continue for the third, fourth, etc. stages. Another related example would involve "starts ahead of sales" where the bank would not allow the borrower to proceed with building new units until a certain amount of sales are completed on the finished units.

### ***Borrower Analysis***

Assuming that the bank is satisfied with the physical aspects and the actual or projected economics of the project offered as collateral, the bank must then assess the creditworthiness of

the borrower and any third-party guarantors.

**Financial Strength.** The bank must determine the financial strength of the borrower by the analysis of the balance sheet, income statement, and any tax returns or other financial data submitted with the loan application. The following concepts should be analyzed for corporate borrowers.

A liquidity analysis would analyze the following:

*Working Capital* – Current assets minus current liabilities, where the higher the positive number, the better.

*Current Ratio* – Current assets divided by current liabilities; bankers like to see a value of at least 1 times.

*Asset Turnover* – Gross revenues divided by total assets, which should be stable. It provides an overview of management's ability to control its assets.

A net worth analysis would analyze the following:

*Leverage Ratio* – Total debt divided by total capital (equity), where a ratio greater than 1 means the borrower is relying more on debt to finance its operations or projects. The higher the ratio, the greater the risk as the borrower has less and less of its own capital at stake.

*Debt Service Ratio* – Annual cash flow divided by annual debt service, where the more above 1 times, the better.

*Return on Equity* – Net income divided by equity, which should be compared to other investments involving similar risks.

**Professional and Business History.** The bank must analyze the borrower's:

Professional and business history by reviewing other properties owned or previously owned (including unsuccessful ventures)

Familiarity and expertise with the type of property offered as collateral

General reputation for integrity and stability

As stated earlier, a first-time borrower should be required to submit a resume of his business history together with banking and business references.

**Source and Availability of Equity.** As stated earlier, the bank must determine the source and

availability of the borrower's equity for the project, whether from other real estate investments, third-party loans, or other business arrangements.

**Assets.** The bank must determine that the borrower has access to sufficient liquid assets, in addition to the required equity, to withstand reductions in income from the property financed due to unanticipated vacancies or other adverse conditions.

**Properties.** The bank must determine the effect of other properties or development projects that will compete for the borrower's time, attention, and working capital.

**Third Party Guarantor.** If the financial strength is to be provided by one or more guarantors, the bank should conduct the same analysis as set forth in steps above with respect to each of the guarantors.

### ***Contractor Analysis***

Underwriting a loan request for new construction entails assimilating a great deal of additional information. In such cases, where the borrower retains an independent general contractor, the bank must:

Determine the capacity of the contractor to successfully complete the project, in terms of employees, equipment, and familiarity with the type of construction; the underwriter should review the contractor's backlog (signed contracts) to see if the project can proceed according to the schedule.

Determine the contractor's familiarity with the city's local rules for building permits and other regulations; the contractor's management (decision makers) must be accessible.

Investigate the contractor's history, with respect to past construction projects, and reputation for quality, honesty, reliability, and ability to handle adverse conditions.

Obtain and analyze financial statements and obtain and investigate banking and business references.

If major subcontractors are employed, conduct the same analysis as set forth in the steps above, with respect to each major subcontractor.

### ***General***



Once the analyses and collection of data described above is complete, the underwriter will prepare the loan submission for Senior Officer, Loan Committee, or Board of Director approval. At this point, the underwriter must be satisfied that the loan proposal is sound, that it is appropriate in light of prevailing economic conditions, and that it is consistent with the bank's policies and its objectives.

## **CHAPTER 6: LOAN APPROVAL**

### ***Introduction***

The bank's Real Estate Loan Policy should clearly describe the loan approval process, including the steps to be taken and the number and level of approvals needed from senior officers within the bank. The number and level of approvals usually depends on the loan size and loan type. There are generally two methods of loan approval:

*Loan committee* – The formal presentation of loan requests to a committee of senior officers, where majority (sometimes unanimous) vote prevails.

*Signature process* – A certain number of officers can sign individually on a loan request.

A separate document that lists officers by name and the loan amounts that each officer is authorized to approve should be maintained. This list should be updated periodically to reflect new names, departures, promotions, etc.

### ***Loan Request Package***

The underwriter will generally prepare a cover sheet that summarizes in outline form all of the essential information concerning the borrower; the property; the guarantors; the contractors; the market; and the proposed loan structure, amount requested, and suggested loan pricing. The recommendation of the underwriter will typically be supported by exhibits, including borrower financial statements, property income and expense statements, photographs, maps, site plans, and an appraisal summary. Together, these documents form the Loan Request Package for officers to review and sign or for presentation to the Loan Committee.

### ***Loan Approvals via Loan Committee or Signature***

Depending on bank policy, the Loan Request Package is circulated to bank officers with sufficient approval authority to approve the loan and provide their signature, or serves as the basis

for an oral presentation at a scheduled Loan Committee meeting, where the loan is discussed the Loan Committee members.

### ***Exceptions***

Loan requests above a certain amount, or that involve exceptions to bank policy, may be referred to the Loan Committee, a more senior approval level, or even to the Board of Directors for approval, depending on the bank's Loan Policy.

### ***Recording***

The original Loan Request Form with the approval signatures should be treated as an important record of the bank, and a system should be established to retain these records under central control and safekeeping, presumably in the Credit Department. At the same time, the amount approved should be logged in with other loan approvals and commitments, so that the bank may monitor its total of undrawn commitments.

### ***Testing***

It is prudent to test the approval procedures annually by auditing a random number of loans to determine if:

- Staff is complying with the loan approval process
- Original approved records are properly recorded and filed
- Reporting requirements to senior management are followed

## **CHAPTER 7: LOAN CLOSING**

### ***Introduction***

Following the loan approval, it is normal for Western banks to issue a Commitment Letter to the borrower. A Commitment Letter is contractually binding on the bank to perform certain actions if the borrower performs as agreed. The letter sets forth in detail the amount and terms that the bank has approved, provides a list of requirements for closing the loan, and establishes timing and performance standards. The advantage of such a letter is that it allows any misunderstandings to be resolved before the parties have incurred significant expense preparing the closing documents. By accepting the Commitment Letter, the borrower has entered into a pre-

liminary contract with the bank. Some banks prefer “Letters of Interest,” or a similar document, to minimize the liability.. A Letter of Interest differs from a Commitment Letter in that it is not contractually binding on the bank and only describes the terms of a loan the bank may be interested in issuing under certain conditions. The normal loan closing procedure for Western banks is outlined below; this practice may differ from the practice in Hungary.

### ***Commitment Letter***

The Commitment Letter will typically include:

- The legal name of borrower and any guarantors
- A description of the required collateral
- The maximum loan amount and maximum loan-to-value ratio
- The minimum debt service coverage ratio
- The interest rate and bases for calculation of require fees, deposits, and payment of expenses
- If new construction or renovation, the permitted commencement and completion dates
- The method of disbursement
- The use of the loan proceeds and the source and method of repayment
- The deadlines for acceptance of commitment and for closing
- The documents required for closing
- The responsibilities of parties and attorneys
- The conditions for funding

### ***Bank’s Responsibilities Prior to Closing***

Prior to the closing, the bank’s underwriters should arrange for the receipt and review of the following:<sup>1</sup>

- Final Appraisal, to verify value and confirm the loan amount\*
- Engineering report, to verify the final project cost\*
- Loan documents
- Complete plans and specifications\*
- Property survey and written legal description\*
- Soil reports and foundation report

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<sup>1</sup> In Hungary, the items marked with an asterisk are required by the bank during the underwriting stage.

All contracts and list of subcontractors  
Developer's cost breakdown for construction project (see cost breakdown)\*  
Detailed construction schedule for construction projects\*  
Evidence of availability of utilities  
Any other items commonly required by Hungarian lending practice

### ***Bank Attorney's Responsibilities***

The bank's attorney will prepare or supervise the preparation of the following materials:

- Loan agreement;
- Assignment of the Building loan agreement;
- Mortgage instrument and assignment of leases and rents or any other income from real estate pledged as collateral (in Hungary the cost to notarize the filing of the mortgage is 2 percent)
- Guarantee agreements
- Other documents or agreements to be signed at closing, including assignment of contracts, insurance documents, performance guarantees
- Other instruments commonly required by Hungarian lending practice (refer to the Legal Exhibit)

### ***Borrower's Responsibilities***

The borrower or the attorney for the borrower is responsible for providing:

- Title documents and evidence of clear title (bank's attorney and borrower's attorney may have to search documents that are pending but not yet recorded at the Land Registration Office in Hungary)
- Current engineer's survey of the property
- Final plans, specifications, and building permits
- Final rent roll, which exhibits tenants, their space in square meters, and rent amounts;
- construction contract and any amendments
- Payment and performance bonds, if available
- Guarantees, leases, and assignment of leases
- Current financial statements for borrower/grantor
- Certificates evidencing compliance with local law
- Evidence that all utilities and services, including electric, gas, sewer, are available;
- Any long-term permanent mortgage loan commitments
- Original insurance policies or insurance binders, which is a summary form that binds the insurance company to providing the insurance coverage
- Corporate resolutions for borrower and guarantor
- Approved construction schedule and requisition form, if an advance is to be made at closing
- Documentation concerning any liens on the property
- Official permit (in Hungary, this permit presupposes that many other permits have already been acquired)

Any other terms commonly required by Hungarian lending practice

### ***Parties at Closing***

The closing should be attended by a representative of the bank, the borrower and their respective attorneys, and any other party required as a signatory, e.g., guarantors, sellers of real estate, etc. Any party with a superior lien or mortgage should be present if they have agreed to subordinate that interest to the bank.

The Loan Officer representing the bank is responsible for seeing that the loan is closed in accordance with the loan approval and the commitment letter. The loan officer may not consent to changes except those that conform to the general principles of the commitment.

The attorney for the bank is responsible for seeing that the parties sign in their proper capacity and for determining that the bank will have a valid mortgage position. The bank representative and the attorney will review and finalize disbursements and repayment procedures. Documents, wire transfers, or other payments called for by the closing documents are held in escrow by the attorney or the bank until title and mortgage documents are recorded, following which the funds are released.

The Loan Officer or the attorney is responsible for completion of a loan closing checklist and, after the closing, for preparing a loan closing memorandum detailing the following:

- Date and time of closing
- List of parties in attendance and their capacities
- Issues that may have arisen at closing
- List of documents received at closing
- Detailed breakdown of all funds disbursed
- Accounting of borrower's equity requirements
- Accounting of fees and expenses collected at closing
- Instructions regarding any future disbursements
- Important dates (e.g., maturity, insurance expiration) that are to be entered in a reminder file

### ***Post Closing***

The administration and servicing of a loan begins the moment a loan is closed, the documents are executed and recorded, and the initial disbursement has been made. At this point

administration of the loan will be assumed by a Loan Administrator, but the Loan Officer will have continuing supervisory responsibilities. The administrator should immediately set up a document file to contain all original recorded and signed documents. These should be maintained in the bank's vault under controlled access and normal security measures. A duplicate file may be prepared containing copies of all important documents (loan application, approval forms, commitment letter, loan agreement, etc.) and should be available for reference by the loan administrators.

### ***Note on Hungarian Mortgage Law***

Because the mortgage laws in Hungary are relatively new and subject to different interpretations, it is imperative that the bank use the services of an attorney who has a thorough understanding of real estate law. This will help ensure that the bank's interests are maintained and that all documents are drafted/executed according to the most recent legislation. In the event of default by the borrower, the bank may have to foreclose on the real estate held as collateral and sell it to satisfy the loan. Therefore, it is critical for the bank to preserve its legal rights to the collateral and be in full compliance with applicable Hungarian law (please refer to Chapter 3).

## **CHAPTER 8: LOAN ADVANCE PROCEDURES**

### ***Introduction***

Construction loans for housing projects are normally advanced (disbursed) in installments during and at the end of the construction period. Great care must be taken during the disbursement phase to be certain that the amount of funds advanced is warranted and that the bank's interests are protected at all times.

### ***Borrower's Equity***

Prior to the disbursement of loan proceeds, the bank must be satisfied that the borrower has invested, or provided for, all of the required equity investment. This can be done by examining paid bills or receipts from contractors, material suppliers, and others. The inspector for the bank should make regular inspections of the work in progress, even during the period when equity is being invested, to measure progress of construction, compliance with approved plans, and actual expenditure of funds. Even after the bank starts advancing funds, the project cost and equity requirement should be recalculated on a regular basis and checked by the inspector throughout the entire construction period. Construction delays, increases in labor and material costs, and other factors can increase the total cost of the project. An increase in the total cost of the project would also increase the borrower's required equity investment, assuming everything else remains

equal. As with the initial equity, the borrower should be required to invest additional equity before any further advance of bank loan proceeds.

### ***Request for Disbursement***

The borrower should submit a formal request for a loan advance that is supported by evidence that the amounts requested by the borrower have already been paid by the borrower, or is currently due and payable to the supplier.. The loan administrator will be responsible for reviewing the request to see that it complies with the construction loan agreement, and particularly the schedule of advances, part of the loan agreement. Given the importance of subsidy allowances in Hungary and the potential liability to the bank if subsidy documentation is not adequate, the loan administrator should carefully review/file all related information. The loan administrator will then order an inspection of the project.

### ***Engineering Inspection***

The construction engineer for the bank, who may be either bank staff or an independent engineer, should be furnished a copy of the application for disbursement, with supporting documentation. Many times, the borrower will submit copies to the loan administrator and the engineer at the same time. The engineer will then conduct a thorough inspection of the project to ascertain the percentage of completion, compliance with plans, and quality of workmanship and materials. The engineer will then certify that the proposed disbursement is appropriate in accordance with the schedule of advances, or suggest modifications or a reduced amount. The engineer should include with this report photographs taken at the time of the inspection to confirm the stage of completion and point out any defective conditions. The engineer's report should include his observations on quality of construction, activity on the project site, any potential problems, and whether the loan funds remaining are sufficient to complete construction.

### ***Title Matters***

In the absence of title insurance, the attorney for the bank should review title documents and public filings prior to each advance to be certain that the bank's lien position has not been impaired. The attorney should also be available to assist the loan administrator with matters of interpretation of title and lien position relating to the next advance of funds.

### ***Stored Materials***

Ideally, the bank would only advance funds for labor and materials that have actually been



incorporated into the construction project. This is impractical in many cases, as construction materials, such as steel, brick, and windows, must be ordered in advance to ensure continuity of construction and to take advantage of favorable prices. Requests for advances for a reasonable amount of materials stored on-site may be approved if the bank and the engineer are satisfied that the materials exist and are safe from weather deterioration and theft. The bank should insist that funds not be advanced for materials stored in a remote location, such as a warehouse. The funds should not be advanced because of the problems presented, since the bank has no claim to the materials unless the bank insists on holding the warehouse receipts or title documents.

### ***Disbursement***

Once the bank and its inspectors are satisfied that an advance request is justified, the disbursements can be made in accordance with the schedule of advances incorporated in the loan documents. Loan advances are normally set using one of the following methods:

**Percentage of Completion.** The percentage of completion method requires the engineering inspector to determine the percentage of completion of each major component of the construction project, and then arrive at an overall percentage of completion for the total project. This is applied against the total loan amount and that sum is disbursed, less the cumulative loan advances previously made. This method is typically employed for larger and more complicated construction projects.

**Staged Payments.** The staged payment method allocates portions of the total loan amount to stages of construction (e.g., foundation complete, roof complete, rough plumbing and electrical complete, etc.). This method is normally used for smaller residential projects and particularly for single-family home construction.

**Approved Requisitions.** Under the approved requisition method, the bank will reimburse the borrower for amounts already paid to contractors or material suppliers, or will pay those creditors directly, once it determines that payments are due.

The actual disbursements are normally made by crediting a deposit account maintained by the borrower at the bank. If required and agreed to in the loan agreement, funds can be credited or paid by cash to a general contractor or others. Such arrangements should be acknowledged in writing by the borrower to avoid future disputes.

### ***Retainage***

It is common to hold back from each loan advance funds of up to 10 percent of the amount of the disbursement, which will be released when the project has been completed to the satisfaction of the bank's inspecting engineer and government authorities. The purpose is to provide an incentive to the developer and his contractors to complete their work on time and in accordance with plans. The retainage for contractors who complete their work early in the project (e.g., a foundation) may be released prior to overall completion of the project, provided the borrower and the bank are satisfied with the performance and quality of that work.

## **CHAPTER 9: INSURANCE**

### ***Introduction***

As of this writing, some of the insurance coverage that is customary in U.S. and Western markets may not be available in every market in Eastern Europe. This section will treat insurance requirements in general terms, so it may be incorporated into the bank's lending practice, as it becomes available. The general rule is that, prior to the loan closing and initial disbursement of funds, the bank must receive evidence of the insurance coverage called for by the Loan Agreement or Construction Loan Agreement. As with other documents and costs, the bank should approve the insurance companies, and the full amount of the premiums should be paid by the borrower.

### ***Property Insurance***

Property insurance covers losses to real and personal property from hazards, such as fire, windstorm, hail, explosions, riot, civil commotion, aircraft, vehicles, and smoke damage. This type of insurance covers properties during construction of improvements and for existing structures. The coverage insures the costs to fully complete or replace the improvements if an accident occurs.

The original insurance policy is defined as the full contractual document that is bought by the borrower in an amount that is sufficient to complete construction (or the full replacement cost if the property is already improved), but not less than the full amount of the loan commitment. The policy should contain a clause or endorsement to indicate that losses will be payable to the bank, or the policy should be assigned to the bank with the written acknowledgment of the insurance company or its agent.

An original insurance binder is a summary of the contract that will follow. The binder is a legally binding document and is normally acceptable provided that it is replaced by the actual policy prior to its expiration date. The policy or binder should be accompanied by proof that the required premiums have been paid by the borrower, and should clearly state that coverage cannot be canceled for non-payment of premium or any other reason without at least thirty (30) days' prior written notice to the bank.

### ***Liability Insurance***

**Borrower.** Liability insurance covers all sums that the insured becomes legally obligated to pay as damages for accidents or occurrences sustained by others, including personal injury or physical damage to tangible property or the loss of use of such tangible property.

The borrower should deliver to the bank an original policy or certified copy of general liability insurance in an amount no less than the amount stipulated in the Commitment Letter, or some specified amount. Proof of payment of the required premiums must be received. As with property insurance, a binder of insurance is acceptable, provided it is replaced by the actual policy prior to expiration. For liability insurance, it is not necessary that losses be payable to the bank.

**Contractors.** If a general contractor is retained to carry out a construction project, the bank must be furnished evidence that the contractor has sufficient, valid liability insurance to cover potential liability exposure to third parties resulting from the contract. The same would apply to major subcontractors.

### ***Other Insurance Coverage***

Where circumstances dictate, the bank should require appropriate insurance coverage in the following categories:

*Flood insurance* – If the property is located in a flood-prone area

*Earthquake insurance* – If located in a seismic zone

*Life insurance* – For key individuals (e.g., owners, managers) where the death of a key person may cause business disruption and jeopardize repayment of the loan; the bank may require such a policy with proceeds assigned to the bank

### ***Title Insurance***

This specialized insurance, which insures that an owner has “good title” to property and that a lender has a valid first mortgage, is available in the U.S. and some Western markets. A title policy is required at closing and is usually updated at the time of each advance under a construc-

tion loan. Premiums are customarily paid by the borrower.

### ***Portfolio Insurance***

A bank may be able to arrange for a master insurance policy, or temporary insurance coverage to protect the bank's interest in the event the insurance on a mortgaged property lapses for any reason. If the lapse in coverage is due to non-payment of premium by the borrower, then the borrower should bear the cost of the temporary insurance coverage.

### ***Surety Bond***

A surety bond is a type of insurance that protects the owner or the bank against the contractor's inability or unwillingness to finish a project. The owner purchases the bond in the favor of the bank.

### ***Insurance Expiration***

The loan administrator will be responsible for:

*Insurance reminder file.* The expiration dates of insurance policies and binders and the premium due dates are to be entered in an insurance reminder file, with sufficient lead time to take action.

*Insurance expiration notices.* The administrator will send a succession of notices to the borrower as insurance expiration dates approach without receipt of evidence of renewal or replacement policies.

## **CHAPTER 10: INTEREST AND PRINCIPAL PAYMENTS**

### ***Introduction***

After the loan agreement is signed, the bank and the borrower have agreed on the method and timing of interest payments and the method and timing of the repayment of principal (or loan amortization). Accurate information must be entered into the bank's records, to allow for proper billing and accounting for payments. If payment by check is not allowed under the loan agreement, payments may be made in cash or by a periodic debit to the borrower's deposit account maintained with the bank.

In Hungary, a certain percentage of the borrower's interest payment may be subsidized. A very large majority of construction financing in Hungary is related to subsidized programs.

### ***Interest Payments***

Interest may be payable monthly, quarterly or annually; the payment schedule should be stipulated in the loan agreement. For proper calculations, invoicing, and reporting, it is important that the bank correctly enter into its accounting system the following:

- The timing of interest payments
- The interest rate, if fixed
- The appropriate base rate and agreed percentage spread above the base rate

Interest may be billed/paid several different ways, depending on the capabilities of the borrower and policy of the bank.

- It can be billed to, and remitted by, the borrower.
- It can be charged periodically to the borrower's current account, or a separate interest reserve account.
- It may be capitalized and added to the principal balance, as is sometimes the case with construction loans.

### ***Interest Calculations***

Interest can be accrued at either a fixed or floating rate, explained as follows.

*Fixed rate.* The rate is fixed for the term of the loan. This would be rare in an inflationary economy, due to profitability reasons.

*Floating rate.* The rate is adjusted periodically at an agreed percentage spread above the base rate published by the Central Bank, or above some other identified international reference rate (e.g., London Inter-Bank Offered Rate, or LIBOR).

### ***Penalty Interest***

In the event of late payments of principal or interest payments, the loan agreement will usually provide for additional interest at a penalty interest rate.

### ***Principal Payments: Amortization***

In addition to interest payments, real estate loans will provide for principal payments

(amortization) that fully repay the total outstanding principal amount by the maturity date. Let us assume in Case 1 a five-year loan, fully amortizing over five years with annual principal payments (for purposes of this example). This loan would require all principal repaid in equal annual payments. Let us assume in Case 2, a five-year loan amortizing over 20 years with annual principal payments. The Case 2 loan agreement provides for a slower rate of principal repayment over the term of the loan and a final, larger “balloon” payment at the maturity date. In both Case 1 and Case 2, all principal is repaid in five years, **but** in Case 2, the annual principal payments in years one through four are much lower than Case 1 (the arithmetic effect of 5-year amortization as opposed to a 20-year amortization). However, for Case 2, the final principal payment at the end of the fifth year is much larger than Case 1 because it is the “balloon” payment to compensate for the lower principal payments made in years one through four.

### ***Total Payment***

If a fixed interest rate is used, it is possible to calculate a percentage of the loan amount, usually payable monthly, applied first to interest at the given rate, and then to principal, which will repay the loan over the desired amortization period. This is a constant payment amount.

If a floating interest rate is used, which is more likely, fixed level principal payments can be made, together with variable interest payments. A steady payment arrangement can be set up using a variable interest rate, but it requires a calculation each month or each payment period to determine how much principal has been amortized.

### ***Principal Payment: Construction***

A construction loan will normally not provide for principal payments, but rather for payment of the full amount that will be advanced by the loan’s maturity. Construction loans are generally repaid by following methods:

The funding of a prearranged long-term permanent mortgage commitment from another lending source (a two bank arrangement); *or*  
Converted to a “mini-permanent” loan by the same lender (a one bank arrangement).

A loan for the construction or housing units may call for loan repayments as the units are sold and released from the lender’s lien (or the bank’s mortgage). This exact legal procedure involving the discharge of the bank’s collateral or parts of the collateral will vary depending on the law that regulates this subject. Once again, legal counsel must be consulted.

Typically, the “release prices” (or the amount of the loan to be repaid for each unit sold) should be calculated so that repayment is accelerated. Acceleration means that the loan will be paid in full before the sale and delivery of the final (or last few) units. The sales proceeds of the final units thus represent profit to the builder, after the loan is paid. The release price should be set up as:

A percentage of the pro rata or average loan amount per unit; *or*  
A percentage of the actual sales price per unit.

To accelerate repayment, the release price should be calculated as follows:

110 percent of the average loan amount; *or*  
90 percent of the sales price; *or*  
Whichever is greater.

Another similar formula for calculating acceleration can be used. A variation on these numbers can be used to either increase or decrease acceleration of loan repayment. Bankers should know that the “release prices” and accelerated repayment provisions should be carefully analyzed and negotiated with the borrower.

### ***Final Payment***

At maturity, or when the borrower has indicated his intention to repay the loan, the loan administrator should review the files and correspondence for any fees or penalties owed by the borrower. It is important that all principal, interest payments, loan fees, penalties, and other amounts due from the borrower be received and collected before the bank releases any mortgages or other security held as collateral for the loan.

If the borrower elects to repay the loan before maturity, the loan administrator should also calculate any prepayment fees that may be required under the loan documents. This may be the case in the instance of a fixed rate loan, where the bank expects a certain amount of income over a fixed period of time, and, therefore, the bank will require fees if the loans are prepaid, in order to compensate the bank for the loss of interest income.

## **CHAPTER 11: THE COLLECTION PROCESS: PROBLEM LOAN ADMINISTRATION**

### ***Introduction***

Bankers know that despite thorough loan analysis, underwriting, processing, and

documentation, events may affect the borrower's ability to repay a real estate loan in a timely manner. Loans become delinquent for a variety of reasons, including mismanagement leading to an illiquid borrower/project, as well as economic and market forces that are beyond the borrower's power. Sometimes loans are reported delinquent as a result of a bank's internal error, for example, a payment mistakenly posted to the wrong loan account.

Effective loan accounting, reporting, and collection procedures are essential for loan collection. This chapter will review some of the administrative elements of collection that the bank may consider when developing its own collection process.

### ***Importance of the Collection Function***

Loan collection is important for several reasons.

Loan collection is a major source of funding to the bank.

The success of loan collection/recovery will affect the bank's profitability.

Poor collection/recovery methods can lead to financial problems for the bank.

Many times banks are rated by Regulators and Rating Agencies according to "performing loans" or loans that are not collection problems.

### ***Functions/Methods of a Collection Department***

The main function of the Collection Department is to recover the loan amount plus interest and any other money due the bank using a variety of recovery methods. Some of these methods include:

Visiting/contacting borrowers who are in arrears and ascertaining the reasons for delinquency, via telephone or sending letters, faxes, etc.

Conducting field visits to the project

Visiting/contacting guarantors

Initiating legal proceedings

Maintaining and updating data on companies that are on strike or lock out

Providing feedback to the lending department on reasons for delinquency and on companies that are on strike or lock out

Trying to work out a long-term solution with the delinquent borrower

Identifying and negotiating with companies for obtaining payment directly from the source, via assignment of rents and others sources of payment



### ***Reasons for Delinquency***

During a visit or telephone conversation, the borrower's reason for delinquency should be ascertained and recorded. The collection of delinquent loan amounts is dependent on the information collected during these visits and conversations. Some of the more common reasons given for delinquency are:

Bank reasons – lending practices or procedures of the bank that result in a lack of careful loan processes and monitoring

Borrower reasons:

- Construction delays, overruns or other problems during construction
- Borrowers affected by unexpected (but often avoidable) economic setbacks
- Business- or market-related problems, like the loss of a substantial amount of apartment Tenants or drastic changes in the demand for housing units
- Poor cash flow from the slow sale of inventory or slow collection of accounts
- Developers branching out into new areas of business without the requisite capital and experience
- Uninsured losses from fire, flood, or other acts of nature
- External borrowings and debts from other projects
- Theft or embezzlement
- Death or sickness of a key principal or partner
- Theft or fraud by the borrower; willful neglect
- Absentee or poor management

Given the wide variety of causes shown above, each borrower must be handled on a case-by-case basis. The reasons for delinquency should be updated in a file and on a computer for future reference. An analysis of the reasons given by a delinquent borrower (perhaps over a period of time) will allow the bank to make better decisions involving the collection of the loan. Facts committed to an officer's memory or reduced to handwritten, hard-to-read hand notes, are not an effective way of updating files.

### ***Deterrents to Delinquency and Loan Losses***

Through careful adherence to underwriting standards, the bank will reduce the likelihood of encountering loan problems. Sound underwriting is the first line of defense to poor loan quality (see Chapter 4) and the guidelines for sound underwriting are restated here for emphasis.

**Analyze the Borrower and Its Prospects.** The bank's loan officer or underwriter should learn

as much as possible about the borrower and the company to more fully understand the nature of its business. Only then can the bank analyze the borrower's information and make a sound and profitable loan. Information that should be obtained from the borrower includes financial information in a form required by the bank, a business or development plan, and background and credit checks that are permissible under the law. After analysis of the borrower and the business, the officer should carefully review forecasts for future company activity and the likelihood of future profitability.

**Analyze the Complexity of the Loan.** After the bank has decided to continue with the loan process, it should ascertain how complex the loan will be, consult with the bank's lawyer, and decide if in-house or outside independent counsel should be used. Counsel should be consulted on all significant or large loans because of the amount involved, the parties involved, and the collateral and/or complexity of the loan or project.

**Discuss the Loan with the Prospective Borrower.** At this stage, it is appropriate for management to instruct the Loan Officer to enter into further, more concrete discussions with the borrower to ascertain the borrower's specific needs and whether a mutually satisfactory agreement can be reached. However, the loan officer must be cautious at this stage and make no statements or representations to the borrower that could be implied as a commitment to lend. The reason is that some borrowers may try to hold the bank liable for an alleged oral commitment to lend to a borrower—the borrower must know that this is a preliminary discussion about a possible loan to the borrower.

**Document the Loan.** After a loan commitment has been negotiated and accepted by the bank and borrower, the necessary loan documents are drafted. The loan officer must follow the closing checklist of items and requirements that the borrower is responsible for providing and be sure that all requirements are met before arranging for the loan closing.

**Monitor the Loan.** The Loan Officer, loan administrator, and other professionals must carefully monitor the progress of the loan and loan advances, ensuring that payments are made on time and that the borrower complied fully with the terms and conditions of the loan documents.

**Educate the Borrowers.** Educating the borrowers at the beginning of the loan process will reduce delinquencies. For example, the bank should inform the borrower of the importance of prompt loan payments to build a strong credit history and of how to reduce the chance of bank error by including with the payment a legible account number (a wire transfer, or other modes of payment, will allow for a loan reference). Moreover, the bank should explain the concept of "late interest" that will be charged for overdue loan payments. The borrower may be familiar with a prior

loan where a “grace period” was used to negate late interest charges for a period of time. Taking time to discuss these and other matters to a new borrower is a good investment by both parties.

**Levy of Additional Interest, Late Fees, and Incidental Charges.** Additional interest should be charged for late payments to compensate the bank for the loss of interest during the period of delay. When this penalty is charged, it may act as a deterrent to making late payments in the future. The penalty interest should be charged on the first day after the payment due date and should be consistently applied for additional late payments unless extraordinary circumstances exist and the bank agrees to waive the penalty.

Additional interest for late payments should be a rate of interest that is higher than the contract rate. In addition, the bank should consider charging out of pocket costs, such as charges for clerks, attorneys, or other professionals in the bank, who spend time processing late payments. Again, the bank's practice in this area is intended to act as a deterrent to delinquent payments as delinquent activity is costly to the bank.

**Setting Goals.** Departmental goals that set a maximum level of delinquencies should be established every quarter in advance for each of the following categories to minimize the level of delinquent loans. These goals should then be distributed to the appropriate parties within the bank.

\_\_\_ HUF/\_\_\_ Number of Loans Over 30 Days Past Due  
\_\_\_ HUF/\_\_\_ Number of Loans Over 60 Days Past Due  
\_\_\_ HUF/\_\_\_ Number of Loans Over 90 and 120 Days Past Due

The actual performance of the department compared to the goals should be reviewed by management on a regular basis. The goals may be revised as needed. An incentive plan or reward system may be used by the bank for its employees to minimize the level of delinquent loans. This procedure has been extremely cost effective for Western banks that incurred significant collection problems with real estate loans during the late 1980s and early 1990s.

### ***Detecting and Understanding Problems***

**Warning Signs.** Warning signs may begin to appear with a loan that bring into question the credit strength of the loan. Bank personnel should try to identify as early as possible any warning signs indicating a possible loan problem. Experienced lenders know that early detection of a problem loan is critical if the bank expects to be able to reverse a negative trend.

As part of the monitoring process, bank personnel should be trained to watch for warning signs that may indicate the beginning of a problem loan. Once a warning sign is identified, the

bank needs to carefully research, analyze, and understand the reasons for the occurrence and watch for further signs of loan deterioration. While it is possible for a warning sign to mean nothing whatsoever, it is better to be cautious and stay alert to ensure that timely actions are taken.

Warning signs include:

- Failure to comply with the terms and conditions of the loan documents
- Sudden end to communication from the borrower
- Liens, tax claims, etc. filed against the bank's collateral
- Disclosure by another lender of problem loans with common borrowers
- Late payments on loans
- Increases in size and aging of accounts receivable and/or payable
- Operating loss for one or more quarters or periods
- Payment to lender or suppliers by illiquid means—notes, barter items, inventory, etc.
- Increased litigation involving the borrower and guarantor
- Delays in response when contacted by the bank
- Illness, resignation, or death one of the principals of the business
- Attempts by the borrower to change the nature or scope of the financed project
- Erosion of the borrower's or guarantor's equity in the collateral
- Death or failure of a primary account debtor
- Increased vacancy rates in surrounding market for the project or other collateral
- Failure to respond to bank's request for financial information
- Sales of housing units or other units are slower than projected
- Incomplete or ambiguous financial information from an experienced firm
- Failure to obtain any necessary governmental or other construction approvals
- Deterioration in the financial condition as reflected in the financial statements
- Changes in the industry or in a particular sector of the economy that could directly affect the borrower's business
- Changes in the purchasing or leasing habits of the marketplace
- New housing projects in the market that will result in the significantly more supply
- A disaster, such as a major fire or flooding, that could adversely affect the borrower's business or projects, even if insured
- Returns/disputes involving sold units
- Payments of significant debts to insiders
- Discovery of fraud
- Numerous requests for extensions of time on payments
- Rumors about the borrower's business from reliable sources that indicate problems with the business

The likelihood of mergers, acquisitions, company restructuring, or other significant structural changes  
A reduction in the scope of the borrower's business  
Changes in management of the borrower or a "shake-up" of existing roles, senior managers, etc.

### ***Investigating Warning Signs and Taking Preventative Measures***

Once a warning sign is detected, one or more of the following steps should be taken by the Loan Officer to determine the seriousness of the situation. (One warning sign may not mean that a significant loan problem exists.) In certain cases, further analysis is required and the Loan Officer and a senior manager will work together on the problem.

Open the lines of communications with the borrower to determine whether there are problems that the borrower will share, up front, with the bank.

Review the title for other liens, mortgages, or encumbrances on collateral that point to problems with the project and explore ways to remove them.

Review new financial statements, if available, to look for signs of trouble (slow sales, increased receivables, net losses, reduced cash balances) and to search for assets that can be contributed as additional collateral.

Review borrower or guarantor accounts: deposit, investment, etc.

Prior to adverse action or litigation, review documentation in the file for defects that should be corrected with the borrower's cooperation to protect the bank's interest, such as changes to documents, expiration of insurance, or expiration of other items subject to renewal.

Review bank's processes to ensure that the problems are not internal problems.

### ***Collection Procedures***

The classification of delinquent loans may be based on the number of days past due (DPD), following the month the payment was due. A loan delinquency list should be generated at the beginning of the second week of each month stating the reasons for the delinquency and indicating the branch location at which the loan was initiated. The staff should verify that all loan payments are updated from the collection area and from the branches before the list is generated.

**Delinquent Letters.** The bank should initiate a series of letters after the staff has verified that the accounts are past due. The following is a suggested schedule for such communications.

An optional warning letter from the collection department on the 10th day following the month (30 days) the payment was due

Letters to first time offenders on the 20th day following the month the payment was due

Letters to other borrowers on the 20th day following the month the payment was due, along with a late fee notice and contact by telephone

Letters to borrowers, who are more than 60 days past due, on the 20th day of the month, along with a late fee notice, contact by telephone, and a planned visit

**Special Visits to Delinquent Borrowers.** If the delinquent account is not resolved via letters, the following steps should be taken:

After 60 days, a bank officer should visit all borrowers with significant sized loans.

The bank should set a policy as to the minimum delinquent loan amount that is required for such action.

After each visit, a letter is sent to the borrower, with a copy to each guarantor, informing the parties of the outcome of the meeting and any commitments made by the borrower to correct the delinquency. A written record is important to clearly establish responsibilities and a record for any legal proceedings.

If no mutual agreement is reached, a direct meeting with the guarantor is recommended.

Another letter should then be sent to each guarantor, with a copy to the borrower.

For all visits, a history sheet of the borrower should be kept and all action taken noted in the file for future reference.

For larger and more complex loans, a senior officer should attend all meetings with the borrower, guarantor, and others.

The presence of bank counsel should be considered where legal action is probable or where senior bank management deems appropriate.

**Special Action for Chronic Delinquents.** For those clients that continue to be past due in making their payments, the bank should follow a prescribed set of actions, which may include:

- Establish rapport
- Determine reasons for delinquency
- Determine reasons for the inability to meet past commitments
- Determine the credibility of the borrower
- Suggest alternatives for the borrower, such as locating a new partner with cash to participate in the project
- Eliminate extraordinary expenses and salaries, even for members of the borrower's family or the borrower himself
- Liquidate personal or corporate assets that are not necessary to the business
- Sell investment property
- Obtain cash or temporary support from family members
- Permit a delay of payments by the bank in certain cases
- Reschedule principal and/or interest payments to match the receipt of cash flow

**Updating Records.** All visits, telephone calls, and conversations with the borrower, plus changes in addresses, telephone numbers, and personnel should be recorded in the file and updated in the computer file. Remember, if the bills and letters are sent to an old or incorrect address or telephone calls are made to the wrong place, the borrower will not receive the information.

**Coordinating and Monitoring.** Collection activity and results should be shared with the underwriters and other loan officers in the real estate area as well as the branches. Specific collection cases may be assigned to officers in the field, including branch officers if they are involved in the transaction. Visits have to be scheduled and coordinated with other departments. Changes or reassignment of cases between officers require careful supervision to avoid situations where the borrower is communicating with more than one officer.

Delinquency information should be shared with other departments to avoid loans being approved by other branches or departments while collection problems are in process with the same borrower. This appears simple but banks are often victims of multiple loans to the same problem borrower because branch #1 made a loan and was not aware that the borrower was already a problem with branch #5. Lastly, a member of senior management should conduct a "past due meeting" on a regular basis with the collection staff to note the progress or problems with delinquent borrowers.

**Reports.** Computer reports should be distributed to the collection manager and staff as well as the head of the department and other members of senior management showing the delinquent

borrowers. The report will sort the loans by the number of days past due, the date of the last payment, the loan amount outstanding, the loan payment amount due, initials of assigned officer, and the maturity date. Some reports also include the contact person at the borrower's place of business and the phone number.

### ***Loan Workout Considerations***

After reviewing the borrower's file, payment history, other records, and any information concerning the "warning signs" stated above, the bank must determine whether a workout or restructuring of the loan is feasible and economically advantageous to the bank. The bank should consider accelerating the loan payments and the maturity date, and exercising the legal remedies available to the bank according to the loan documents. If the workout course of action is attempted, the following steps should be considered:

*Agree to a Pre-Workout Letter.* Banks often have the borrower sign a pre-workout agreement, which is a standard letter agreement prepared by the bank's legal counsel. The letter's primary clause states "In return for the Bank's forbearance from taking immediate legal action, the borrower waives any and all claims and actions it may have against the Bank and its officers."

*Negotiate Waivers, Amendments, or Restructure the Loan.* The bank may want to consider changes and amendments to existing documents to give the bank flexibility in dealing with the borrower and to prevent further aggravation of a problem situation. Repayment schedules and loan covenants may be changed and the bank may agree to waive exercising certain rights. This rationale provides the borrower with additional time to rectify and improve the situation.

*Changes to the Loan Terms and Structure.* Changes to the loan terms may include extending the loan period, changing the interest and principal payments, adding guarantors, or adding new collateral.

*Additional Collateral.* Part of the workout may include the borrower or guarantor pledging more collateral for the loan. Counsel is needed especially in this situation as issues relating to bankruptcy or other creditors may arise. Such issues can include determining true ownership rights and any claims on the new collateral.

*Conducting Audits.* When the borrower's financial information is not forthcoming or not reliable, the bank may consider exercising its rights under the loan covenants or other



grounds to require an independent audit by a reputable accounting firm at the borrower's expense. The goal is to produce a reliable financial profile of the borrower and the project.

**Foreclosure.** When the borrower defaults and fails to pay the money owed to the bank, and all other workout efforts to resolve the default have failed, the bank must consider foreclosure as the primary vehicle for recovery of the outstanding loan. Branches and other departments of the bank should not resort to foreclosure without permission from the appropriate senior officer(s).

Foreclosure is normally tried as a last resort, when all efforts to reach a long-term solution with the borrower have failed. Once foreclosure laws have been tested and shown satisfactory for the bank and its counsel, foreclosure is a viable alternative. Until foreclosure becomes more common, each case should be carefully documented and the file should contain a copy of all documents and a report of the court proceedings. This will allow the bank and its counsel to build their own "learning file" that will assist with foreclosure cases in the future.

**Loan Workout vs. Foreclosure.** When faced with the choice between a workout arrangement with the borrower or a foreclosure action against the borrower, the basic question to answer in banking is: Which course of action will maximize the recovery to the bank? The bank needs to determine the total cost for the various alternatives based on the expected loan duration or the property holding period. Other factors the bank should consider include the environmental cost or liabilities for the bank to own a given property, the claims or damages that the borrower may bring against the bank if the bank begins foreclosure action, as well as other issues. Some of the basic factors the bank should consider include the following:

**The Borrower.** What is the character of the borrower, its commitment to the project or business, and its expertise to manage the property or run a business? Does the borrower add value to the project or business? Will it contribute to the future success or failure of the project or business? One should consider:

- Experience and reputation in the market
- Ability to attract and negotiate tenant leases, suppliers, etc.
- Financial capacity to fund the project, additional overhead, staffing and maintaining key personnel
- General willingness to work with the bank through a problem loan

**The Guarantor.** A similar analysis may include the guarantor. Special attention must be paid to the guarantor's financial ability to fund cash requirements of the property or business and its ability to carry out any operational responsibilities. Another question: Will the guarantor cooperate?

**Economic Value.** After proper analysis, what makes the most economic sense, a workout or foreclosure? This analysis may be a discounted cash flow analysis based on the proposed restructure terms versus an analysis of foreclosure. The foreclosure analysis would include assumptions concerning the length of time required to take back the property, the cost of foreclosure and the expected holding period with an assumed sale price, and the discount rate as well as capitalization rate of interest.

**Foreclosure Preparation.** The bank should consult counsel experienced in foreclosure and real estate law. For foreclosures in remote locations or locations outside of the primary market area, local counsel is consulted to determine the proper foreclosure and court procedures in that particular jurisdiction.

The Loan Officer or assistant should follow the bank's policy, review the appropriate documents, and order the necessary reports. Special attention should focus on defaulted loan provisions and covenants, the title, enforceability of loan documentation, survey of the property, notifications of foreclosure, and environmental issues.

**Accepting the Deed to the Property.** It is not uncommon for the borrower to offer the property to the bank rather than go through the foreclosure process. The bank should have a written checklist of issues that should be considered before the bank accepts the offer. This list should include questions similar to those involving foreclosure and ownership issues, such as the condition of the title, the existence of claimants rights, environmental issues, governmental approvals, etc.

## CHAPTER 12: REPORTING REQUIREMENTS

### *Introduction*

Reporting is an important administrative function. It provides department management and senior management with portfolio information needed to assess the bank's market position and establish lending strategies to enhance that position. Reporting is also important from the standpoint of control and asset/liability management.

***New Loan Requests***

New loan applications should be reviewed for compliance with bank policy and a preliminary analysis should be performed to determine the likelihood of approval. If an application is accepted, it should be entered by name of borrower on a Loan Request Status Report. This report should be changed and updated when necessary to reflect changes in the loan status, and should be distributed monthly to permit department management, senior management and other interested parties to track the status of active loan applications. A loan should be carried on this report for one month following the loan closing, and then deleted.

***Loans Closed***

A report should be published monthly showing loans closed during the period. This report should include the following details:

- Borrower name
- Amount of commitment
- Interest rate
- Commitment fees
- Name/number of Loan Officer

This report may not require wide circulation in the early stages of a real estate lending program. However, as volume increases and more departments and more officers become involved, the distribution list will expand.

***Portfolio Summary Report***

A report should be published monthly that summarizes all loan accounts, showing for each the total commitment, outstanding balance, undisbursed amounts, and payment status of loans (e.g., current, 30 days past due, non-accrual, etc.). Also, projected annual profit to the bank from the borrower's relationship is important data to show in this report. Obviously, downloading this information automatically is preferred.

***Delinquency Report***

A report should be published monthly showing delinquencies, listing by category and loan type, loans that are non-accrual, 90 days past due, 60 days past due, and so on. The report should include identifying information, responsible loan officer, and comments on the loan status.

### ***Loan Watch List***

A report should be published monthly showing loans that may be current but because of an anticipated default, or other reason(s), require a closer-than-normal level of supervision.

### ***Other Reports***

The reports suggested above are management tools that have proved effective for loan officers and management in monitoring the commercial real estate loan portfolio. Each bank must develop a reporting system that will best allow it to monitor and control its real estate lending activities. Other reports may be added at the request of management, or if customary or mandatory under an individual bank's policy.

## **ANNEX**